Understanding the Key Characteristics and Benefits of Municipal Bonds

While your 401(k), IRA, and Social Security will provide you with income during retirement, they may fall short of the mark when it comes to how you envision your post-work life. Which is why it’s important to have an income strategy that meets your basic needs and helps you live the retirement you envisioned. Municipal bonds can be an attractive investment option for investors nearing the distribution phase.

What are the Municipal Bonds?
In the United States, state and local governments and public entities like universities, hospitals, and utilities districts issue municipal bonds to fund vital infrastructure development. According to some records, the modern U.S. municipal bond came about in the early 1800s, when New York City issued the first general obligation bond to finance the construction of canals from the Hudson River to Lake Erie and Lake Champlain.

Today, there are two major types of municipal bonds:

- **Revenue bonds** repay bondholders using revenues from the project the bond initially financed, such as toll road collections or university tuition payments.

- **General obligation bonds** are backed by the “full faith and credit” of the issuing governmental entity and can be repaid using revenue, income, or property taxes.

What Should Investors Know About Municipal Bonds?
Beyond these designations, it’s important to have a deep understanding of the different characteristics of municipal bonds prior to investing in them. The following are the primary features and pricing considerations common to most municipal bonds:

- **Tax Status.** Most municipal bonds are excluded from gross income for tax purposes by the Internal Revenue Code. However, while tax-exempt in many cases, bonds are still subject to some tax implications and you should speak with your tax advisor to get a more accurate picture of how they can impact your return if you plan to invest in them.

- **Interest.** Also referred to as the coupon rate, interest is the annual rate as a percentage of principal that you will receive on a bond, not counting any discount or premium in purchase price.

*Please see disclosure on page 3.*
• **Yield.** The annual return you will receive on a bond taking into account the purchase price. Yield is also expressed as yield-to-maturity (the amount of money you receive from payments of principal and interest if the bond is held to maturity) and yield-to-call (the rate of return you earn from principal and interest payments in the case that the bond is redeemed on a specific call date).

• **Bond Price.** The amount you pay to buy a bond, which can be priced three different ways: at par (the amount of principal you’ll receive when the bond matures), at a discount (a bond priced below par, when an investor pays less than face value), and at premium (a bond priced above par, when an investor pays more than face value).

• **Maturities.** Bonds are issued in maturities ranging from one to 30 years. Some bonds, called Serial Bonds, are issued with a series of scheduled maturity dates while others, called Term Bonds, are issued with a single maturity.

• **Interest Payment Date.** When you can begin receiving interest payments on a bond.

• **Call Provisions.** When a state or local government redeems a bond at a specific price prior to its stated maturity date. When an issuer exercises a call, you receive the principal amount of the bond and can be eligible for an additional premium.

**Why Do People Invest in Municipal Bonds?**
Municipal bonds might be a good investment for investors for various reasons. While tax-exempt interest is their main selling point for many investors, there are a lot of reasons you should consider adding them to your investment portfolio, including:

• **Wealth preservation and income generation**
  Municipal bonds might be for investors who are seeking to preserve their wealth and simultaneously earn tax-free income. Investors receive regular interest payments until the bond reaches its maturity date, in which your originally invested cash is returned in full.

• **High credit quality and decreased default risk relative to other asset classes**
  According to Moody’s report, “U.S. Municipal Bond Defaults and Recoveries, 1970-2017,” municipal bonds have historically observed high credit ratings and low default rates. Credit ratings take into account the risk of default and indicate risk of potential loss to investors. According to the Municipal Securities Rulemaking Board (MSRB), the municipal securities default rate is 0.18 percent compared to 1.74 percent for corporate securities.

• **Greater after-tax returns than many taxable bonds**
  Municipal bonds often boast a higher after-tax yield than taxable bonds. Even if a taxable bond offers a higher interest rate, municipal bonds sometimes prove more attractive because interest earned is exempt from federal income taxes and sometimes state and local taxes as well.
• **Consistent and predictable income**  
  Purchasing municipal bonds is a way to prearrange a steady source of income. In exchange for your loaned capital, you receive scheduled interest payments over a predetermined time period. You can also manage regular cash flow more efficiently by implementing a bond ladder strategy, which can help minimize reinvestment risks by investing in bonds with multiple maturities.

• **Community-focused investments**  
  Because municipal bonds fund projects that add value to communities, your investment helps grow your own wealth while also contributing to community improvement. And you’re not alone. According to the MSRB, municipal bonds fund two-thirds of U.S. infrastructure projects and individual investors hold two-thirds of the nation’s municipal securities—either through direct investments or indirectly through mutual fund investments.

**A Leading Municipal Investment Bank**

More and more Baby Boomers are retiring every day, approaching a phase of distribution where they’ll require a steady stream of income. As one of the top municipal advisors in the United States, our active involvement in the fixed income markets provides us with unique access to municipal bonds.

Our visibility into the characteristics of individual bond products helps us find products that align with your goals, time horizon, and risk tolerance. By analyzing the coupons, maturities, and yields of individual bonds, our financial advisors can help you build tailored portfolios with the capacity to provide steady income and well-timed opportunities for reinvestment.

To find out more about investing in municipal bonds, [find a HilltopSecurities financial advisor](#) near you.